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Washington Office of the Insurance Commissioner

CC: PricewaterhouseCoopers

Cantilo & Bennett

FROM: The Blackstone Group

RE: Premera Share Allocation

DATE: May 25, 2004

This memorandum has been prepared in response to (i) Signal Hill Capital's ("Signal Hill") "Supplemental Report on Proposed Conversion of Premera Blue Cross," dated February 27, 2004 (the "Signal Hill Report"); and (ii) the letter from the State of Alaska, dated May 10, 2004, to the Honorable Michael Kreidler (the "Alaska Allocation Letter"). The Blackstone Group ("Blackstone"), solely for the purposes of this memorandum, has focused its comments on that portion of the Signal Hill Report, which addressed the appropriate allocation between Washington and Alaska of shares in Premera Blue Cross ("Premera" or the "Company"). The Alaska Allocation Letter commented on the most recent allocation reports of Blackstone and PricewaterhouseCoopers ("PwC").

Overview

TO:

Blackstone prepared on two separate occasions⁽¹⁾ an analysis of the appropriate split of proceeds between Washington and Alaska in the proposed conversion of Premera. In preparing its most recent report, Blackstone utilized 2000–2002 historical data provided March 21, 2003 (E867) and updated financial information since Blackstone's original report. The updated data included 2003 actual and 2004 budgeted data provided March 26, 2004 (E626), and 2005–2006 projected planning tool data provided October 17, 2003 (E590).

Blackstone relied on Premera's judgment regarding the categorization of various lines of business in Washington and Alaska, respectively. Blackstone analyzed the relative contribution of the Washington and Alaska operations on both a historical and projected basis for certain operating and financial metrics including members, revenues, underwriting margin, contribution margin, operating income and net income. This methodology is consistent with how investment bankers generally analyze the relative valuation between two businesses or two segments within a company.

In formulating its allocation range, Blackstone also considered certain qualitative factors such as scale, mix of business and growth prospects. These are all factors that would be important in any

Blackstone submitted its original allocation report on August 1, 2003 and a subsequent updated allocation report on March 30, 2004.

relative valuation and customarily would be considered by investment bankers in contribution analyses such as Blackstone's allocation report.

In addition, Blackstone notes that this is an investment banking analysis of relative ownership and we have relied upon PwC to develop an actuarial analysis on this topic. (1)

Comments on the Signal Hill Report Regarding Allocation

Blackstone would offer the following observations regarding Signal Hill's Report:

1. Signal Hill has based its allocation range upon an analysis of operating income, GAAP net income, adjusted net income⁽²⁾ and adjusted net worth⁽³⁾ without consideration of other financial or operational metrics.

The investment community typically examines a much broader set of financial and operational metrics, such as members, revenues, underwriting margin and contribution margin, in order to analyze relative valuation between two businesses or two segments within a company. Additionally, Blackstone believes that members, revenues, underwriting margin and contribution margin may have fewer discretionary concerns than operating income, net income and net worth due to the allocation of certain operating expenses. An examination of historical allocation trends demonstrates that operating expenses have not been allocated with a large amount of consistency or logic. PwC describes these concerns in greater detail in its reports. Therefore, Blackstone has developed its perspective on allocation by evaluating a broader and potentially more appropriate set of metrics.

Based upon an examination of members, revenues, underwriting margin and contribution margin on a historical and projected basis from 2000 to 2006, Washington's relative contribution ranged from 85.7% to 93.0%. This range is meaningfully greater than Signal Hill's estimated allocation range for Washington of 70.4% to 74.2%.

2. The Signal Hill Report has not incorporated Premera's revised management projections.

Signal Hill based its analysis upon management projections that were prepared in March 2003, 14 months prior to the date of this memorandum. While the revised projections were not prepared with the same amount of detail as the original projections provided by the Company, these projections do represent management's most current and best estimate of the future performance of Premera's Washington and Alaska operations.

⁽¹⁾ For more detail regarding this issue, please refer to the PwC allocation reports dated February 18, 2004 and March 26, 2004.

⁽²⁾ Signal Hill has defined adjusted net income as GAAP net income adjusted based upon a reallocation of investment income given estimated historical capital levels for Washington and Alaska respectively. The reallocation of investment income is per Signal Hill's estimates.

⁽³⁾ Signal Hill has defined adjusted net worth as accumulated net worth adjusted to reflect certain adjustments that Signal Hill has made with respect to GAAP net income (e.g., adjusted net income).

Given that the revised projections⁽¹⁾ were provided in October 17, 2003 and March 26, 2004, these forecasts in particular represent the most accurate view of the Company's expected earnings in 2004 and beyond.

3. Signal Hill's utilization of adjusted net income and adjusted net worth as relevant benchmarks in determining its valuation may be problematic.

Signal Hill has calculated an adjusted net income metric that allocates investment income on a basis that is different from the Company's methodology. The Company's methodology for allocating investment income is based upon the earnings contribution of individual business units and is consistent with the practices of several health and life insurance firms.

Signal Hill's investment income assumptions, which it utilized to calculate adjusted net income, may be problematic for several reasons; (i) the starting capital values for Washington and Alaska are based on assumptions which may be incorrect; and (ii) the revised methodology may not fully take into account the significantly greater float income generated from Washington operations.

4. Signal Hill appears to have placed greater emphasis in its analysis on the historical performance of the Washington and Alaska operations versus their expected future performance.

The Signal Hill Report has evaluated seven years of historical data and four years of projected data in developing its allocation range. While investment bankers typically examine historical performance when determining relative contribution, a significant emphasis is usually based upon future performance of a selected company or segment. By definition, a potential shareholder needs to be assured that the expected financial performance of a company supports the price of the company's stock. Based upon the figures in the Signal Hill Report, the average Washington contribution related to GAAP net income during the projection period is approximately 3 to 6 percentage points higher than Signal Hill's revised allocation range. As described previously, there are several potential issues with Signal Hill's underlying net income figure (i.e., uses dated projections, allocation of operating expenses, and questionable recalculation of interest income).

5. Signal Hill's allocation range changed considerably from its initial report to its final report without a compelling explanation.

While Blackstone and PwC have not revised their respective allocation ranges, Signal Hill's revised allocation range has changed materially from its original report. Signal Hill's original allocation range for Washington was 55.6% to 71.8% as detailed in Signal

⁽¹⁾ The revised projections include 2004 budgeted data provided March 26, 2004 (E626), and 2005 – 2006 projected planning tool data provided October 17, 2003 (E590).

Hill's report dated October 22, 2003. Signal Hill's revised allocation range for Washington is 70.4% to 74.2%, which is nearly 17.2%⁽¹⁾ higher than the original range.

Response to the Alaska Allocation Letter

Set forth below is our response to Signal Hill's review of the Blackstone allocation recommendations dated May 13, 2004 and submitted before the Insurance Commissioner of the State of Washington. Signal Hill's review is incorporated as part of the Alaska Allocation Letter. The italics represent Signal Hill's comments, which are followed by Blackstone's responses.

- (1) "Blackstone reviewed the relative contribution of the Alaska and Washington operations and also included "public market" factors, including considering the businesses as if they were stand-alone companies. This approach is flawed for the following reasons:"
 - a. "It appears to look at the Alaska and Washington operations as separate companies, even though they have never been run as such and there are no plans to change that"

Blackstone never stated or conducted its relative contribution analysis assuming that Alaska would be a stand-alone company from Washington. There are several examples where the investment community values an entire company based upon an analysis of each division / business unit. In many of these circumstances, the business units have always been operated together and such an analysis does not imply that such units are "separate companies".

From a structural perspective, the Blackstone relative contribution methodology is very similar to that of Signal Hill; however, different levels of emphasis were placed on various measures of operating performance. Given that the fair value of Premera will be determined by the public markets, Blackstone believes that it would be appropriate and customary to consider selected qualitative factors that public market investors would consider in assessing a business.

b. "It appears to place greater emphasis on measures that do not take into consideration the full revenues and expenses of delivering healthcare to customers, i.e., it emphasizes financial results and projections that do not include operating expense or investment income, which are two important components of the economics of healthcare products and their profitability"

Consistent with Wall Street practice in performing a contribution analysis, Blackstone considered several operating and financial metrics including members, revenues, underwriting margin, contribution margin, operating income and net income. Net income does include operating expense and investment income, and operating income does include operating expense. Blackstone has placed greater emphasis on members,

⁽¹⁾ Equal to the percentage increase from 61.7% (the specific allocation recommendation of Signal Hill as stated in its October 22, 2003 report) to 72.3% (the midpoint of Signal Hill's allocation range as stated in its February 27, 2004 report).

revenues, underwriting margin and contribution margin given the lack of certainty surrounding the operating income and net income figures. This is in part due to (i) the lack of agreement among the Washington and Alaska actuaries regarding the allocation of operating expense and investment income between the Washington and Alaska operations, and (ii) discussions with Premera regarding the accuracy of such allocations. Despite this, Blackstone notes that it did consider both operating income and net income. In fact, under Premera's most current projections, the 2004–2006 projected operating income would result in an allocation of 86.0% for Washington, which is consistent with Blackstone's indicated range. In addition, the 2005 and 2006 net income forecasts are not available due to insufficient data provided from the Company to perform our analysis.

c. "In assessing allocation and valuation, rather than using the valuation measures commonly employed by Wall Street analysts and bankers, Blackstone uses less prevalent measures"

As discussed earlier, Blackstone has taken into consideration all the valuation measures commonly employed by Wall Street analysts and bankers, including operating income and net income.

d. "It improperly emphasizes future performance, as though a sale were occurring, even though future performance is less certain than actual history and there is no planned sale"

Blackstone has taken historical, current and future performance into consideration in order to develop a complete understanding of the operating and financial performance of Washington and Alaska. We note that Blackstone did take historical performance into account. In fact, utilizing cumulative historical members, revenue, underwriting margin and contribution margin would result in an allocation to Washington of 91.3%, 87.6%, 88.0%, and 87.9%, respectively. Given that the fair value of Premera will be determined by the public markets, it is reasonable to emphasize future performance in the relative contribution analysis, because although the public markets take historical information into account, there is a major focus by public market investors on the future performance of the business.

Signal Hill focused more on history than future prospects, which is inconsistent with the way investment bankers and public equity markets attribute value to companies or divisions within companies. In addition, a public market valuation by definition does not represent the value associated with a sale. There are several studies that indicate that sale or change-of-control transactions, on average, typically reflect a significant premium to the public market valuations of the public companies.

(2) "Blackstone analyzed Premera's projected financials for 2000 to 2007 (subsequently shortened to 2006), without explaining why it excluded the 1997 to 1999 years from its analysis. Of note is that during the years 1997 to 1999, the Washington operations experienced operating difficulty"

In its original allocation report, Blackstone used 3 years of historical data and 5 years of projections, (1) which is fairly common for investment banking analyses (see previous comments on how public equity investors view companies). In its revised allocation report, fiscal year 2007 was excluded due to lack of available data in Premera's revised projections.

(3) "Blackstone asserted that operating income and net income include several allocations made by Premera, including operating expenses and investment income, that may be less reliable indicators of allocation and value. However, Blackstone did not explain why it believed that Premera's allocations are unacceptable"

The company's allocation of expenses resulted in Washington having a higher operating expense PMPM result relative to Alaska in certain historical years, which is inconsistent with both certain prior historical years and the projected financial results. For example, according to Premera's 2003 operating expense allocation methodology, Washington has an operating expense PMPM of versus for Alaska. Based on our discussions with PwC, it is their view that it does not make sense that Washington's operating expense PMPM would be higher than Alaska's.

- (4) "Blackstone's view of allocation was affected by a number of improper valuation considerations, and its assertions were improperly analyzed, for example:"
 - a. "'The Alaska operation would be vulnerable as a stand-alone company.' The Alaska operations are certainly viable, based on the historical stability of the business, and the Washington operations are themselves vulnerable on a stand-alone basis due to its operating infrastructure and cost base"

Blackstone has never stated that the Alaska operations would be "vulnerable" as a As previously discussed, Blackstone considered several stand-alone company. qualitative factors that public market investors might consider important in analyzing relative contribution. Blackstone believes that scale is important for managed care companies, and that the public market investors may reward scale with a premium valuation multiple. Washington has a tremendous advantage in scale with 92.4% of the total cumulative 2004 - 2006 members. In an Accenture study dated November 23, 1999, outlining competitive advantages in the managed health care industry, several benefits of scale were described which include (1) increased negotiating leverage with health care providers (particularly a function of regional scale); (2) ability to spread certain fixed costs and investments, such as capital expenditures and new product development costs over a larger customer / revenue base; (3) potential for greater diversification in terms of geographic coverage, product mix or customer base; (4) a decreasing administrative cost ratio as local market share increases; (5) consolidation of processes, systems and staff functions that may include legal, tax, accounting, product management, and marketing; (6) more effective medical

⁽¹⁾ Blackstone analyzed financial performance from 2000-2007 in its original allocation report dated August 1, 2003, and analyzed financial performance from 2000-2006 in its updated allocation report dated March 30, 2004.

b. "'The fee-for-service basis of the Alaska operations is problematic.' The demographics and nature of Premera's markets determine the basis of business and the Alaska operations should be profitable if Premera is able to maintain pricing increases in-line with costs trends"

Blackstone has never stated that the fee-for-service business in Alaska is "problematic." However, Blackstone did note that most contracting in Alaska is on a fee-for-service basis with some PPO business, as managed care has never really gained widespread acceptance. While it is true that the demographics and nature of Alaska's markets determine the basis of business, managed health care (HMOs, PPOs, POSs) is often more cost efficient from a business perspective in comparison to fee-for-service. It may be relatively more difficult to manage the profitability of a fee-for-service product in a world with rising and uncertain health care costs. As such, the fee-for-service basis of the Alaska operations is a relevant qualitative factor in regards to the relative contribution analysis.

c. "'Washington has a higher growth rate.' Relying on growth rate is problematic because Premera's historical growth efforts have been inconsistent with respect to profitability and growth in Washington may be unprofitable, which would not add value"

Blackstone's qualitative factors in determining the relative contribution also state that growth is important, and that like scale, public market investors reward growth with a premium valuation multiple. Washington has substantially better growth prospects than Alaska, and this should therefore be taken into consideration in the relative contribution analysis. In addition, Blackstone has focused on growth in earnings, which is by definition "profitable growth" as it already reflects the costs associated with such growth.

For instance, from 2003–2006, the Company is forecasting only a compound annual growth rate in operating income for Alaska as compared to a compound annual growth rate for Washington over the comparable period. The public BlueCross BlueShield companies (WellPoint, Anthem, and WellChoice) all have projected IBES long-term mean EPS growth rates of between 14.0% and 15.2%. For net income from 2000–2003, Washington had a positive compound annual growth rate, while Alaska had a negative compound annual growth rate. For the current fiscal year (2004 versus 2003), Washington is forecasting positive net income growth of versus a decline in net income for Alaska.